DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

January 11, 2010

The Honorable Keith Ellison
United States House of Representatives
Washington, D.C. 20515

Dear Representative Ellison:

Thank you for your letter on the important issue of capital requirements for banking firms and other major financial firms. Please accept my apology for this delayed response. Your letter expresses concern about the amount of leverage that banking firms and some non-bank financial firms were able to amass in the run-up to the financial crisis, and you specifically ask whether a leverage requirement for banks and other financial firms should be included in statute.

I agree with you that leverage constraints are a critical part of an effective regulatory capital framework and that enhanced regulatory capital requirements are a critical part of financial regulatory reform. That is why the Administration successfully pushed for the G-20 Leaders to endorse a supplementary leverage ratio as part of each nation's regulatory capital framework for banking firms. And that is why we also have supported efforts by the Basel Committee on Banking Supervision to develop an international agreement on the form, structure, and level of such a supplementary leverage ratio. We have called for a leverage ratio that incorporates off-balance sheet items and have advocated for the application of leverage and risk-based capital requirements to any financial firm whose failure could pose a threat to financial stability.

I am pleased to report that on December 17, 2009, the Basel Committee released for public comment a proposal on an international leverage ratio and is on track to finalize global regulatory capital standards by the end of 2010, for implementation by 2012. This is consistent with the timeline set forth by Treasury in its September policy statement on capital and later endorsed by the G-20 in Pittsburgh.

Although the Administration strongly supports imposing a simple, non-risk-based leverage constraint on banks, bank holding companies, and other major financial firms, we do not believe that codifying a specific numerical leverage requirement in statute would be appropriate.

Devising and calibrating regulatory capital requirements is a complex endeavor. The effects of regulatory capital requirements that are set too low include losses to the deposit insurance fund and financial instability. The effects of regulatory capital requirements that are set too high include reduced credit availability and economic growth. The regulatory process is not perfect, but it is designed precisely to collect the information and conduct the empirical analysis necessary to calibrate regulatory capital requirements that maximize financial stability at the least cost to economic growth.

In addition, the financial markets are dynamic, and it is imperative that regulatory capital requirements be able to adapt quickly to innovation and to changes in accounting standards and other regulations. Placing fixed, numerical capital requirements in statute will produce an ossified safety and soundness framework that is unable to evolve to keep pace with change and to prevent regulatory arbitrage. Fixed, numerical statutory capital requirements also could hinder the Federal Reserve and other banking agencies as they strive to make their capital requirements less pro-cyclical and explore the costs and benefits of making capital requirements affirmatively counter-cyclical.

Past attempts by Congress to legislate minimum capital rules for financial firms have been ineffective. The statutory leverage constraint and detailed statutory risk-based capital requirements for Fannie Mae and Freddie Mac proved to be inadequate to the task of ensuring the safety and soundness of the firms. The inability of the Federal regulator of Fannie Mae and Freddie Mac to design more appropriate capital requirements for these firms because of the statutorily mandated capital rules likely contributed to the need for the government to place the firms into conservatorship in September of 2008.

Finally, preserving the flexibility of the Federal Reserve and the other U.S. banking agencies to design and calibrate a leverage constraint for U.S. financial firms is essential to enable the agencies to successfully negotiate a robust international leverage ratio that works in all the major jurisdictions and does not leave U.S. firms at a competitive disadvantage to their foreign peers.

Thank you again for your commitment to these critical issues, and I look forward to working with you as we enact comprehensive regulatory reform legislation.

Sincerely,

Timothy F. Geithner

cc: The Honorable Ben S. Bernanke